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IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 624

MARIS MCLEAN, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR REHEARING OF CERTIORARI

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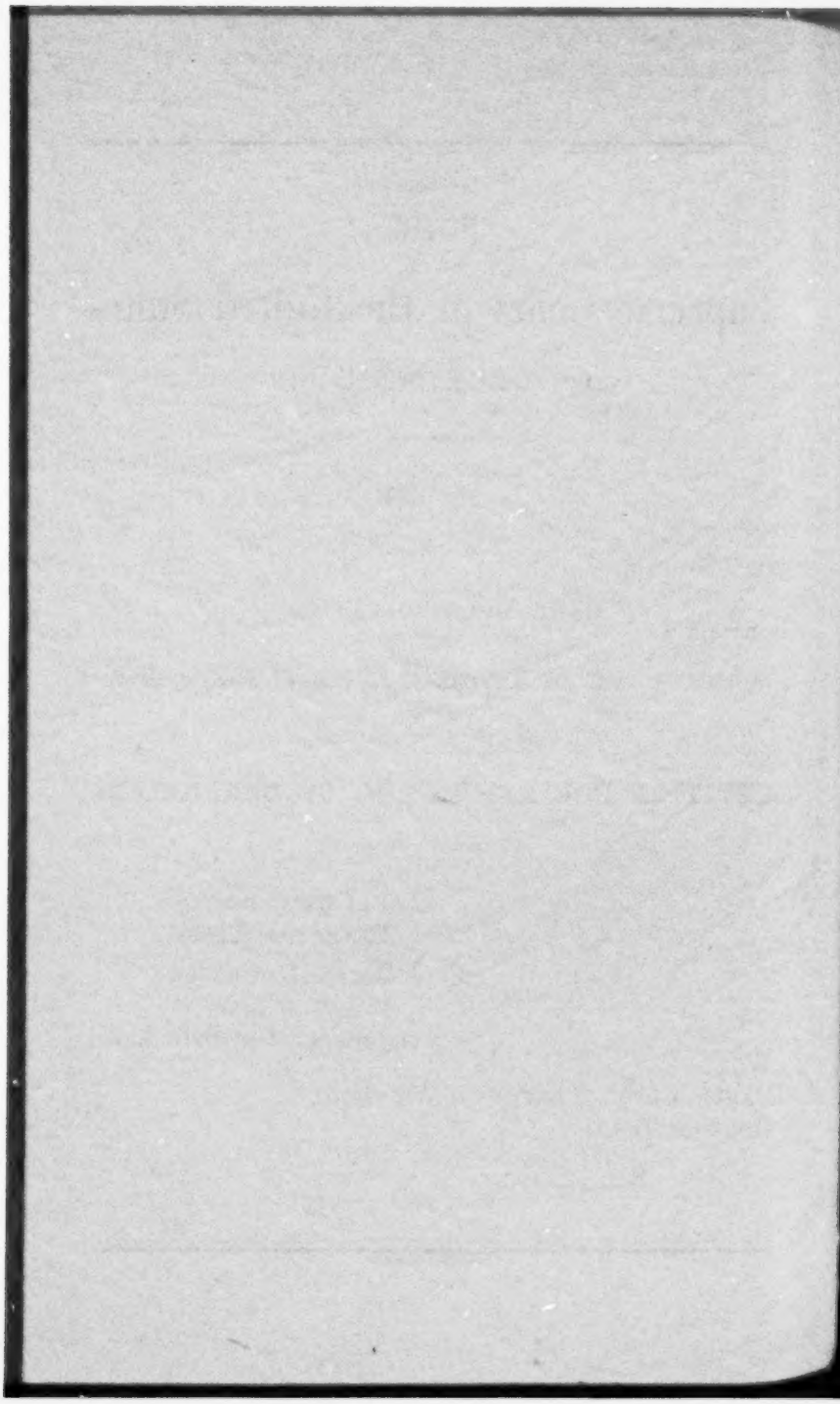

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To The Honorable Chief Justice and
The Associate Justices of the
Supreme Court of the United States:

On October 27th, petition for certiorari was denied in this case, wherein review was sought of the decision of the United States Circuit Court of Appeals for the Fifth Circuit, reported in 120 Fed. (2d) 942. Certiorari was and is the only remedy available to this petitioner, the case being brought before Your Honors under Section 347, Title 28, U. S. C. A., and under Supreme Court Rule 38-5(b). This petition for rehearing is filed under Supreme Court Rule 33.

THE QUESTIONS

The questions involved are whether the fact that an assignor of an oil lease has a right to receive "royalties" and "oil payments," *controls the nature of the transaction,* regardless of the form of the instrument and the intent of the parties, to the extent of depriving the assignor of the benefit, both as to the cash consideration and the "oil payments" involved,(1) not only of the Capital Gains provision, but also (2) of what we term the *"Prospector's Relief"* provision (Sec. 102) of the applicable Revenue Acts, which limits the surtax of an individual who discovers and develops an oil field. The second question will be discussed first as the *primary basis upon which reconsideration is sought* in this petition for rehearing.

THE GROUNDS

There are special and important reasons why this petition for rehearing and the application for certiorari should be granted, as follows:

I.

Important Questions of Federal Law To Be Settled.

When the Honorable Chief Justice was Associate Justice of this Honorable Court in 1932, he wrote the opinions in three cases which were of general importance to the oil industry, because of which fact they were all reviewed by the Court on applications for certiorari. Those cases all appear in Volume 287 of the United States Reports, and are as follows:

Burnet v. Harmel, 287 U. S. 103, which dealt with the Capital Gains provision, only as to an oil *lease,* not a transfer thereof.

Murphy Oil Company v. Burnet, 287 U. S. 299, which dealt with the method of allowing depletion on a bonus received under an oil lease;

Palmer v. Bender, 287 U. S. 551, which dealt with the circumstances under which a transferor of an oil lease would be entitled to invoke what might be termed the Discovery Value Depletion provision [Sec. 214-(a)10, Revenue Act, 1921].

This case involves one entirely different feature of the Income Tax Laws, the provision limiting the *surtax of an individual* who discovers and develops an oil field and later makes a *bona fide* transfer thereof (Sec. 102 of the 1928 and 1932 Acts, designated above as the Prospector's Relief provision). That provision was adopted originally during the World War period at the instance of the National Petroleum War Service Committee as Section 211(b) of the 1918 Act, and is now substantially embraced in Section 105 of the present Internal Revenue Code. It has never been construed or applied by the Supreme Court so far as we can determine, though it was involved in the Board's decision in the case of *Helvering v. Tex-Penn Oil Co.* (28 B. T. A. 917), which was later decided on other points by the Supreme Court (309 U. S. 481). In that case this Honorable Court looked through the form of a transaction which the Commissioner had classified as "indivisible" in order to hold that a tax-free "reorganization" had resulted despite the receipt of cash which the Supreme Court found was consideration to

the stockholders and not to the corporation. In so ruling the Court quoted with approval the following:

> "* * * the rule is well settled that in determining tax liability, taxing authorities must look through form to fact and substance."

In this connection attention is called to the fact that the Prospector's Relief provision (former Section 102) expressly deals with a "*bona fide* sale," thus indicating that the good faith intention of the parties as to the nature and effect of the transaction should control, rather than the mere technical form.

The term "bona fide sale" is, of course, almost identical with the term "bona fide purchaser," and both terms have a well understood meaning under the law. It is universally recognized that those terms are concerned primarily with the *bona fides* of the transaction rather than the exact classification of the transaction from the standpoint of conveyancing. In fact, it is said in 66 *Corpus Juris,* 1095:

> "It is not necessary that a purchaser should claim the fee-simple estate; if he acquires a leasehold estate for value and without notice, he will be protected."

The term "bona fide sale" has been used in other Federal Revenue enactments. In fact, it appeared in the Revenue Act of 1918 (as did the enactment involved herein) under Section 402(c), which is now in substance Section 811 (c) of the Internal Revenue Code. That section deals with the gross estate to be reported under the Estate Tax Law and makes particular provisions with reference to "transfers in contemplation

of or taking effect at death." It provides that the gross estate shall include all such transfers "except in case of a *bona fide sale* * * *." (Italics ours.) The only difference between the original enactment and the enactment as it now appears deals with the language prescribing the nature of the consideration involved, as follows:

> *1918 Act:*
>
> "Bona fide sale for a fair consideration in money or money's worth."
>
> *Internal Revenue Code:*
>
> "Bona fide sale for an adequate or full consideration in money or money's worth."

This change was made only to narrow the broad interpretation of the original requirement as to the *consideration,* but had nothing to do with the character of the transaction from the conveyancing standpoint. *Taft v. Commissioner,* 304 U. S. 351; *Commissioner v. Bristol,* 121 Fed. (2d) 129 (First Circuit). In any event, the Prospectors' Relief provision here involved (Section 102 of the 1928 and 1932 Revenue Acts) is not limited by any designation of the type of consideration to be received by the grantor.

The case of *McCaughn, Collector, v. Carver,* 19 Fed. (2d) 126 (Third Circuit), dealt squarely with the meaning of the term "bona fide sale" as used in Section 402, *supra,* and concluded that it was broad enough to embrace a trust created by a man for his wife in pursuance of an antenuptial agreement. On that point the Court said:

> "At first blush one who *stood on the literalism*

of the statute would say that it was not a sale in the ordinary *mercantile acceptation* of the term. But we find the definition of a sale in Webster is 'the transfer of property * * * from one person to another for a valuable consideration or for a price in money.' * * * Under such circumstances it may reasonably be contended that such a transfer as this *fell within the spirit* and the definition *meaning of the word 'sale.'*

"The substantial element the law considers is not so much the form as *the good faith* and the fair construction of the transaction. Seeing, then, that the law is *fairly open* both to the construction placed upon it by the Commissioner of Internal Revenue, on the one hand, and by the judge below, on the other, and that this uncertainty of construction confronts the application of the law to the state of facts here involved, the general principle that all doubtful constructions must be resolved in favor of the taxpayer would seem to warrant an affirmance of this judgment, if we had—which we do not have—any doubt upon the correctness thereof." (Italics ours.)

A similar conclusion was reached in the case of *Ferguson v. Dickson,* 300 Fed. 961, where the Third Circuit Court, dealing with the same provision of the statute, said (at page 963):

"Many courts have defined a legal sale:

"It is 'a transmutation of property from one man to another in consideration of some price.' 2 Blackstone, 446; Dunn v. Mayo Mills, 134 Fed. 804, 810, 67 C. C. A. 450. 'A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent.' Five Per Cent Cases, 110 U. S. 471, 478, 4 Sup. Ct. 210, 214 (28 L. Ed. 198). 'A sale is a contract by which, for a consideration, one *transfers to an-*

other property or an interest therein.' Yick Sung v. Herman, 2 Cal. App. 633, 83 Pac. 1089, 1091. 'A sale is a contract whereby one acquires a property in the thing sold and the other parts with it for a valuable consideration.' Cole v. Laird, 121 Iowa 146, 96 N. W. 744. *'Every transfer of property for an equivalent is practically and essentially a sale,* and * * * money's worth is a valuable consideration (for the sale) as much as money itself.' Huff v. Hall, 56 Mich. 456, 23 N. W. 88." (Italics ours.)

As late as 1938 this Honorable Court had the same provision of the Act before it in the case of *Helvering v. Bullard,* 303 U. S. 297, and apparently only refused to apply it in that case because the trust therein involved had been declared "void and ineffective" so that the widow "took no interest under it" and therefore could not "spell out a sale."

At the time that the transaction involved in the ininstant case occurred, the Prospector's Relief statute dealt with "a bona fide sale of *mines, oil or gas wells,* or any interest therein," instead of as now "a bona fide sale of ony oil or gas *property,* or any interest therein." The earlier language clearly indicates that the Prospector's Relief provision in its origin was interested primarily in the disposition of the production from the property, and resulting control of the shaft or wells as the case might be, instead of the disposition of the technical title to the property from which the production was derived. This interpretation of the Prospector's Relief provision is reflected in the case of *Fowler v. United States,* 11 Fed. (2d) 895,

wherein the Court, referring to that provision of the law, said:

> "This was for the purpose of stimulating prospecting and exploration, and that the law might be fair to the prospector, who had expended years and money in a fruitless search. * * * If a man who finds is to be deprived of a large part of his profit through large surtaxes, he will prefer to *hold* what he finds."

As indicated it was the "holding" or disposition of the property with which that provision was concerned, rather than the technical features of the title. That is doubtless why the statute prescribed as a feature which would entitle the taxpayer to relief his *bona fides* in transferring the "wells *or any interest therein*" without regard to whether he retained an overriding royalty. In this connection, the Supreme Court in applying the Discovery Value Depletion provision in *Palmer v. Bender* held that there it was not restricted to any "special form of legal interest in the oil well" or to those who are "technically lessors."

In the instant case, it is stipulated that Marrs McLean and wife discovered and developed the oil field, and considered that they were making a "sale or exchange." (Record 215 and 223.) Surely the right to invoke the Capital Gains provision or the Prospector's Relief provision should not be defeated by the fact that the Court put a liberal interpretation on the depletion allowance in the case of *Palmer v. Bender*. The allowance of a depletion deduction is only "an act of grace" (*Anderson v. Helvering*, 310 U. S. 404, at p. 408). It was recognized to be such by

the petitioner in the case of *Palmer v. Bender*, petitioner's brief in support of application for certiorari containing at page 29 the following statement:

> "Since depletion is *purely a grant* from Congress, the sole question here is one of construction of the depletion provisions of the Act and the validity of the Regulations specifically authorized by those provisions for the allowance of the deductions."

Indeed, the petitioner advanced as Point One under his argument there (page 21) the following:

> "Art. 215(a), Regulations 62, as amended, is a reasonable interpretation and application of the depletion provisions of the Revenue Act of 1921, and should not be disturbed."

This leads to a discussion of the effect given to that case in subsequent cases classifying oil transactions as "subleases," subject to depletion, or as "sales," within the meaning of the Capital Gains provision.

The petitioner contended that by every test that could be applied to his transaction, there was no feature or factor that could determine it to be a lease or sublease. It conveyed not just a part of the acreage in the Cade leases, but it conveyed all. It conveyed not just a part of the petitioner's working interest in the Cade leases, but it conveyed all. The transaction not only did not impose any obligations to be performed by the assignee, but specifically protected the assignee against any implied obligations, by the stipulation in (c) of the consideration, "It being expressly understood in this connection that the Yount-Lee Oil

Company shall be under no obligation whatever to the grantor herein to drill upon or develop said land, or any part thereof, for oil." The petitioner also pointed out that the well recognized and accepted feature in leasing and subleasing transactions—that of "reversion" to the grantor—was not provided for in the transaction. The petitioner contended that as to what he assigned he had parted with completely and made delivery of it to the assignee, "Lock, stock and barrel, with no strings attached," and that the transaction could not be otherwise than a sale.

Contrast the petitioner's transaction with that in *Palmer v. Bender,* where there was transferred only a part of a lease, and the transferees were charged with obligations to carry out and perform, for the benefit of the transferors—clearly a subleasing transaction.

The taxpayer intended to make a sale, and sincerely believes that the substance of his transaction confirms that he did, yet the Fifth Circuit Court, on account of the reservations alone, construed his transaction to be a sublease. In doing so, the Fifth Circuit Court was continuing and applying a new rule or doctrine of the law, set up on its own initiative, that reservations determine the nature of transactions.

It would indeed be anomalous if "an act of grace" extended to a taxpayer in *Palmer v. Bender* should create "a rule of thumb" to deprive a taxpayer of other acts of grace such as were intended by the Capital Gains provision and particularly by the Prospector's Relief provision.

It is not believed that the Supreme Court ever in-

tended to substitute for its judgment or the judgment of any other court, in interpreting a contract, any arbitrary rule or factor or test which alone should be determinative of the nature of the transaction, regardless of the language used and the intent of the parties. It is further believed that this Honorable Court, as now composed, has reflected a liberal attitude toward reconsideration, ~~not only of~~ including decisions rendered by the present Court; the latter as instanced by the action of the Court at this term in granting rehearings (including rehearings on applications for certiorari) in certain cases involving civil rights between employers and employees, and rights of parties in criminal prosecutions. While those matters are important they are perhaps no more so than cases involving the oil industry without which there would be few employers and fewer employees.

It is vital to those who develop or deal in the oil industry to know under what conditions they may obtain some relief from taxes that might otherwise make their transactions prohibitive. This was true when in *Palmer v. Bender* this Court construed the Discovery Value Depletion provision. It is equally important today when construction is sought of the Capital Gains provision and particularly the Prospector's Relief provision, which has never been construed by the high court. There has been some effort on the part of the Treasury Department to prescribe some rule to follow generally in oil transactions, but confusion still exists (see recent G. C. M. 22730 captioned):

"(Oil and gas leases: Tax status.) Status of

> oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties."

The General Counsel's Memorandum is set out in full as an appendix to the original petition for *certiorari* filed herein (at page 40). In that Memorandum the General Counsel, speaking of the decision in the case of *Palmer v. Bender,* says:

> "The opinion states that a lessor, or sublessor or *assignor,* who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil in place *entitling him* to depletion deductions against *cash bonus payments* as well as proceeds from his share of the oil." (Italics ours.)

If the Supreme Court in the *Palmer case* held that an *assignor* (as distinguished from a lessor or sublessor) would be *entitled* to depletion on bonus, as well as oil payments or royalty, it certainly did not hold that such an assignor might not instead reserve a royalty and at the same time make a sale of the balance of his interest, which would entitle him to the application of the Capital Gains provision or the Prospector's Relief provision. In other words, the Supreme Court in that case must have, we believe, by applying its rule of looking "through form to fact and substance," concluded that the intention of the

parties was to make a sublease (under the general law, if not the Louisiana law). It would seem hardly fair to say that this conclusion was forced upon the Court by the sole fact that an overriding royalty ran throughout the transaction. Otherwise, there would remain no "freedom of contract," so far as oil transactions are concerned.

The General Counsel's Memorandum also says:

> "A cash payment representing proceeds from the sale of an *economic interest* also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss * * *." (Italics ours.)

If an oil payment is an "economic interest" then its sale like the sale of a royalty would result in a capital gain or loss; yet different effects are sought to be given to the two types of "economic interest" so far as determining the character of a transaction is concerned. For instance the Memorandum continues:

> " cash payment made upon the execution of an instrument stipulating *only for oil payments* is, therefore, regarded not as advance royalty payment but as proceeds from a sale." (Italics ours.)

On the other hand if the factor of royalty is involved, the transaction *ipso facto* is treated as a sublease, and the cash consideration as a bonus subject to depletion. Yet the only possible difference between royalty and "oil payments" is one of possible duration, not one of kind; and even the duration will

be the same where production fails, or else ceases before the "oil payments" are completed.

The quotations from the General Counsel's Memorandum emphasize the importance of having this Honorable Court review the decisions of the lower Federal Courts.

It has been almost ten years since the three cases first cited herein were decided by the Supreme Court, and during that period of time there have been many interpretations and attempted extensions of those cases in decisions by the lower courts, some of which for one reason or another have never reached the high court. The majority of those cases emanated as was to be expected from the Fifth Circuit Court of Appeals, whose decisions in the case of *Burnet v. Harmel,* 56 Fed. (2d) 153, and in *Palmer v. Bender,* 57 Fed. (2d) 32, and the cases originating out of the transaction therein involved [*Waller v. Commissioner,* 40 Fed. (2d) 892 (certiorari denied); *Herold v. Commissioner,* 42 Fed. (2d) 942] and related cases [*Ferguson v. Commissioner,* 45 Fed. (2d) 573, and *Pugh v. Commissioner,* 49 Fed. (2d) 76] had been mainly reversed or overruled. In those decisions the Fifth Circuit Court had given much weight to the rules of law established by the decisions of the State Courts where the oil properties were located, but that Court learned from the decisions of this Honorable Court in *Burnet v. Harmel,* and *Palmer v. Bender,* that when interpreting the Federal Revenue Acts, it should be controlled by the decisions of this Honorable Court without regard to the interpretation of the local law. Since then, it is believed it may be said that the Circuit Court has at-

tempted to adhere rigidly (perhaps too rigidly) to the "rule of thumb" (or to use a more modern term—"yardstick") prescribed.

The statutes and regulations and decisions of the Supreme Court provided for depletion to a lessor on his bonus and reserved "royalties," using the plural and inclusive term. In no instance in the statutes, treasury regulations, nor decisions of the Supreme Court has there been any subdividing of "royalties" (plural and inclusive) into component or singular parts, giving to such component parts a different value or different treatment from that provided for "royalties."

Wholly without support in the statutes, treasury regulations, or decisions of the Supreme Court, the Fifth Circuit Court, by a number of decisions, none of which has been reviewed by the Supreme Court, is setting up a new doctrine in the law of determining the nature of transactions by their reservations, in total disregard of the substance of the transactions.

The Fifth Circuit Court has subdivided "royalties," in its plural and inclusive meaning, into "royalty," and "oil payment," and has given to each an interpretative and determining value, so that in effect that Court is setting up what might be termed "The New Doctrine of Determining Transactions by Their Reservations," to set at naught the intent of the statutes, treasury regulations and the decisions of the Supreme Court.

This new doctrine holds that if the reservations provide for "royalty" (in its singular sense) in the transaction, the transaction is *ipso facto* regarded as a lease

or sublease, regardless of the substance of the transaction. If the transaction provides for a reservation of only an "oil payment," the transaction is *ipso facto* a sale, regardless of its substance.

The petitioner will take the liberty of discussing and quoting from some of the Fifth Circuit Court's decisions, none of which have been reviewed by the Supreme Court, so that this Honorable Court has had no part in the establishment in the law of this new doctrine of determining the nature of transactions by their reservations. If this doctrine is established, which it will seemingly be, if the petitioner's writ is denied, it will result in confusion, uncertainty and doubt, because the application of such doctrine results in definite conflict with the intent of the statutes and decisions of this Court.

The petitioner will briefly quote and discuss the Fifth Circuit Court's decisions in the cases of *Fleming v. Commissioner,* 82 Fed. (2d) 324, *Cullen v. Commissioner,* 118 Fed. (2d) 651, and *McLean v. Commissioner,* 120 Fed. (2d) 942. These decisions will definitely show the erroneous, unjustified and unsound new rule or doctrine of law being set up by the Fifth Circuit Court, that reservations are determinative of the nature of such transactions.

The Fleming Case.

In the Fifth Circuit Court's decision in the case of *Fleming v. Commissioner,* 82 Fed. (2d) 324, the Court said:

"In Palmer v. Bender, however, the transferror

> reserved an additional royalty, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus or advance royalty."

There is nothing in the Palmer decision, directly or by inference, that held that Palmer was a sublessor because of the "royalty" reservation, yet the Fifth Circuit Court makes the declaration above that *because* a "royalty" was reserved, the transaction in *Palmer v. Bender* was found to be a sublease, thus overlooking the fact that the Supreme Court based its decision on the *substance* rather than the form of the transaction. Here, for the first time, a lower court holds that the reservation determines the nature of a transaction. This statement of the Fifth Circuit Court has remained for years unchallenged, because this case and cases following it in the Fifth Circuit Court were not appealed.

The Cullen Case.

The case of *Cullen v. Commissioner* before the Fifth Circuit Court, 118 Fed. (2d) 651, involved the transfer of twelve oil leases to the Humble Company. Nine of the leases reserved an "oil payment" and an excess "royalty." The other three leases provided for a reservation of an "oil payment," but no excess "royalty." All twelve leases were transferred in the same transaction, with the same stipulations, imposing obligations and terms on all leases alike.

The Fifth Circuit Court said in that case:

> "Within the purview of Palmer v. Bender percentage depletion was allowable on all payments

> received as a result of the transfer of those leases in which the taxpayer retained overriding royalty interests. As to the three leases in which no overriding royalty interests were retained percentage depletion should not have been allowed upon the portion of the cash payment attributable to their sale. Commissioner v. Fleming, 82 Fed. (2d) 324, Laird v. Commissioner, 97 Fed. (2d) 730."

The Court here uses the type of reservation to determine the nature of the transaction, holding that the transfer, as to the nine leases reserving "royalty" is to be treated as a sublease with depletion to be allowed on bonus, and reserved interest, but that the transfer as to the three leases reserving only an "oil payment," is to be treated as a sale, with no depletion to be allowed on the cash consideration.

The McLean Case.

The petitioner, in his argument before the Fifth Circuit Court, attacked that court's decision in the *Cullen case,* as to reserved "royalty" being a determinative factor for treating a transaction as a sublease, and the use of an "oil payment" as being a determinative factor for treating a transaction as a sale. The petitioner urged that a reserved "royalty" could not be used as a demarcation point between a sale and a sublease, and that the kind of economic interest reserved was not determinative of anything, and that there was no justification for this ruling in the Statutes, or the decisions of the Supreme Court. The petitioner contended that while his transaction provided for a cash consideration, an oil payment and

a reserved royalty, as did the Palmer transaction, yet the substance of the transactions showed that there was no similarity in their nature and import, and petitioner urged the Court to follow the rule of the Supreme Court to construe transactions on their substance.

The Commissioner answered, as is stated in the Fifth Circuit Court's opinion, as follows:

> "The Commissioner with the rejoinder that 'this is a typical Palmer v. Bender case' would make short shrift of all these arguments and contentions. Invoking Cullen's case in further support, he insists that all else aside, *the reservation of the royalty settles and completely disposes of any question* which might have been in the case if the reservation *had been only of an oil payment.*" (Italics ours.)

There was no argument made by the Commissioner that the *substance* of the petitioner's transaction showed it to be a subleasing transaction, as it was in the *Palmer case,* instead of a sale as contended by the petitioner. The whole basis of comparison used to show that the transaction of the petitioner, and that involved in the *Palmer case,* were similar, or typical of each other, was that both transactions provided for a cash consideration, an oil payment and a reserved royalty.

The contention of the Commissioner was based on the erroneous idea—the new doctrine of determining reservations—that the kind of reservation was the only thing that counted in determining whether the transaction was to be treated as a sublease or a sale. The

Commissioner's contention that the royalty reservation "settles and completely disposes of any question, which might have been in the case * * *" was sustained by the Fifth Circuit Court.

The Fifth Circuit Court in its decision against the petitioner said:

> "Without undertaking any detailed or nice analysis of the language in the instrument upon which the taxpayer relies * * *."

(In this statement, that Court waives aside any necessity for examining the substance of the contract, and shows its lack of concern with its substance) and continues:

> "we think it plain that the transaction as a whole comes strictly within the ruling in the Palmer v. Bender and Burnet v. Harmel cases. Precisely as in Palmer v. Bender, the taxpayer here in the instrument of transfer, reserved in himself an interest in the oil in place. * * * Precisely as in Palmer's case, the taxpayer here retained a right to a share in the oil as produced. * * * Precisely as in that case the taxpayer obtained * * * a part of the fruits of the land as they might be produced, both as to the royalty and as to the payments in oil."

The Fifth Circuit Court definitely bases its decision against the petitioner on the ground that his transaction provided for "precisely" the same reservations as that involved in the *Palmer case* transactions. In so doing that Court says it is strictly within the ruling in the cases of *Palmer v. Bender* and *Burnet v. Harmel.*

There is no ruling in the *Palmer case* that the *reservations* had any more effect than to create, *as to them,* a right to depletion. There is no ruling that the kind of reservations had any interpretative or determinative value as to the nature of the transaction. Nowhere in that decision did the Court rule that a reserved "royalty" was the factor that determined Palmer's right to depletion on his *bonus.* Nowhere in that case did the Court rule that if Palmer had reserved only an "oil payment" interest, his transaction would have been construed as a sale. In no place did the Supreme Court rule that any economic interest differed in value from another.

The petitioner relied on *Thomas v. Perkins* and the *Elbe cases* to support his contention that he was not entitled to depletion on the proceeds from his sale. They were clear, clean-cut decisions, carefully discussed and construed on their *substance,* but the Fifth Circuit Court, in the instant case, after deciding that the similarity of reserved interest brought the transaction strictly within the rulings of the *Palmer v. Bender case,* said:

> "Nothing either in the opinion in the Elbe case, or in its application of its principles to its facts, affords taxpayer any comfort. That opinion reaffirms Palmer v. Bender, *and the result there was reached because there was no reservation of royalty,* there was no retention of ownership, * * *." (Italics ours.)

In this the Fifth Circuit Court declares that the lack of a "royalty" reservation resulted in the Elbe transaction being construed to be a sale.

The fact that there was no "royalty" reserved did not determine one single thing about the transaction being a sale or sublease, and the Supreme Court did not, we understand, hold that the absence of a "royalty" reservation made the transaction a sale.

If the Elbe transaction had been worded throughout, as it was, but had added an exception, so as to reserve a "royalty," there is little doubt that the Supreme Court would still have found it to be a sale as to the cash and profit interest, but would have allowed depletion on the reserved "royalty"; which is a right to share, and an economic interest entitled to depletion such as was held in the *Palmer case* to apply to both a royalty and an oil payment, and such as was held to apply to the reservation of an "oil payment" in the *Perkins case*. In one instance, the *Palmer case*, depletion applied to the reservation in a sublease. In the *Perkins case* it applied to the reservation in a sale.

What would be the situation if a landowner, selling a tract on which no oil was developed, reserved from the sale *all the oil, gas and minerals*, with rights of ingress and egress to develop? Would this be a sale as to what was assigned, or would it be a sublease? Such transactions are universally regarded as sales; so also would a transaction be a sale if an assignor, instead of reserving all of the oil and gas rights, *reserved only a one-eighth royalty.*

Can there be any doubt that this Honorable Court would hold in the case of a sale of the land with either all of the mineral rights reserved, or a royalty interest reserved, that the transaction was a sale as to that part assigned, and that the money received was con-

sideration for that part? Many transactions of this nature are made. What is the difference between the McLean-Yount-Lee transaction and that? McLean was in the position of being the owner, with full vested rights in the fee to the oil and gas. As owner, he made a sale, transferring every interest he had in the working interest and 75 per cent of the oil in these leases. He made his transfer so complete that Yount-Lee became invested with the complete title to the working interest and to 75 per cent of the oil. Should McLean's royalty reservation prevent this transaction from being a sale, when the reservation of the entire mineral rights or of the royalty interest would not have that effect on the transaction if the sale was by a landowner?

If McLean's assignment had been limited and restricted and had provisions for reversion, the situation, of course, would be different. This was not the case. McLean's interest was just as certain as that of the landowner, and his assignment was just as definite and complete, so why should a royalty reservation be treated differently in his transaction than it would be in the event of a sale and reservation by the landowner?

II.

Conflict and Confusion In Federal Court Decisions.

Some of the cases which were decided by the Fifth Circuit Court, after the decision of this Honorable Court in the case of *Palmer v. Bender*, which never reached the High Court, and which involved important

questions pertaining to the oil industry, may be listed as follows:

Fleming v. Commissioner, 82 Fed. (2d) 324.
Blankenship v. United States, 95 Fed. (2d) 507.
Laird v. Commissioner, 97 Fed. (2d) 730 [and 91 Fed. (2d) 498].
Cullen v. Commissioner, 118 Fed. (2d) 651.
Columbia Oil & Gas Company v. Commissioner, 118 Fed. (2d) 459.

Other late decisions from the Fifth Circuit Court are:

Badger Oil Company v. Commissioner, 118 Fed. (2d) 791.
Roeser & Pendleton, Inc., v. Commissioner, 118 Fed. (2d) 462.
Crabb v. Commissioner, 119 Fed. (2d) 772.
Sneed v. Commissioner, 119 Fed. (2d) 767.

A case that was decided by the Fifth Circuit Court, which did reach this Honorable Court, is *Thomas, Collector, v. Perkins,* 86 Fed. (2d) 954 (301 U. S. 655). Cases from other courts of a similar nature, which were never reviewed by the Supreme Court, include *Heep Oil Corporation v. United States,* 32 Fed. Supp. 762 (U. S. Court of Claims); *Hammonds v. Commissioner,* 106 Fed. (2d) 420 (10th Circuit). In *Spalding v. United States,* 97 Fed (2d) 701 (9th Circuit), certiorari was sought but denied.

The Fifth, Ninth and Tenth Circuits involve primarily the states where the production of oil prevails, and this large body of jurisprudence has been built up in these circuits without substantial guidance from the Supreme Court since its decision in *Palmer v. Bender.*

True, the Supreme Court did review from the Ninth Circuit the case of *Commissioner v. Elbe Oil Land Development Company,* 91 Fed. (2d) 127 (303 U. S. 372), and from the Tenth Circuit the case of *Anderson v. Helvering, Commissioner,* 107 Fed. (2d) 459 (310 U. S. 404), in addition to the case of *Thomas, Collector, v. Perkins, supra,* from the Fifth Circuit. However, none of those cases dealt squarely with the question involved in this case or that involved in the case of *Palmer v. Bender,* as to whether the *right of an assignor to receive an oil royalty* converted the assignment from a "sale" into a "sublease"; *particularly* none of them dealt with the *"Prospector's Relief" provision, which, as stated, has never been interpreted or applied by the Supreme Court.*

No hesitancy is felt in saying that the lower courts are now in utter confusion as to what rule of reason or principle should guide them, and that accounts for their adopting a "rule of thumb" or "yardstick" which they assume to have been applied by the Supreme Court to transactions of this nature.

Even if such a new standard or "chemical test," determined by particular factors, is to be applied, for lack of a better guide, petitioner urges that it should not be adopted and applied retroactively to transactions of this nature which like the one here involved occurred even before the decisions in the case of *Burnet v. Harmel, supra,* and *Palmer v. Bender, supra.*

In this connection, it is pointed out that the stipulation in the instant case provides that the transfer "was considered by the petitioners (Marrs McLean

and wife) as the sale or exchange of a capital asset" (Stipulation, paragraph 29, Record 223) and that "the principal value of the leases was demonstrated by prospecting and exploration and discovery work done by Marrs McLean and wife during said period." (Stipulation, paragraph 4, Record 215.) These quotations from the stipulation invoke the application to this transaction of the Capital Gains provision or in the alternative the Prospector's Relief provision.

The unsettled state of the law is further reflected by the following features in decisions of the lower courts:

(a) Judge Hutcheson in the instant case, commenting on the attitude of the Commissioner:

> "Invoking Cullen's case in further support, he insists that all else aside, the reservation of the royalty settles and completely disposes of any question, *which might have been in the case* if the reservation had been only of an oil payment. * * *
>
> "We are not at liberty to repudiate or, at this late date, to *even question* those principles (referring to Palmer v. Bender and Burnet v. Harmel, supra). We think too, that it (the Cullen case) completely disposes against him, of appellant's whole Sec. 101 case, and renders it unnecessary for us to consider what we ought to do with it here if this were a case like Fleming's was, and like Cullen's was in part, of cash and oil payments, *without the reservation of an additional royalty.*" (Italics ours.)

(b) Judge Sibley in the *Fleming case:*

> "In Palmer v. Bender, however, the transferor

reserved an additional royalty, and so was in reality a sublessor, and the cash paid him *could more readily be treated* as a bonus or advance royalty. * * * Section 102 (Prospector's Relief provision), however, makes a special provision 'in the case of a bona fide sale of mines, oil or gas wells, *or any interest therein,*' where the principal value is due to the taxpayer's explorations of the property, limiting the tax to 16 per cent of the selling price. The last-mentioned section is important here as particularly recognizing *sales of interests* in such property as is here involved, and providing for their taxation." (Italics ours except words "or any interest therein.")

(c) Judge Foster's dissent as to the denial of depletion on the cash consideration in the *Fleming case* and his subsequent abandonment of that position and extension of the doctrine in the *Fleming case* to the transaction involved in the case of *Laird v. Commissioner,* 97 Fed. (2d) 730.

(d) Judge Sibley's majority opinion in *Sneed v. Commissioner, supra* (certiorari now pending) and Judge Hutcheson's dessenting opinion in *Crabb v. Commissioner, supra,* dealing with restoration of depletion in the event of non-production.

(e) That portion of Judge Phillips' opinion in *Hammonds v. Commissioner, supra,* under the caption "Was Petitioner Entitled to a Depletion Allowance?".

(f) The three separate opinions of the judges of the Ninth Circuit Court in the case of *Elbe Oil Land Company v. Commissioner,* 91 Fed. (2d) 127, parti-

cularly the language of Judge Wilbur, reading as follows (at page 130):

> "If the case at bar cannot be distinguished from the decision of the Fifth Circuit Court of Appeals in Commissioner v. Fleming, supra, because of the fact that the two $400,000 payments involved here were to be optional with the purchaser, and thus were obviously dependent upon the result of exploratory operations for oil, and because of the fact that the vendee had the right to surrender the premises at any time before the payment of the second $400,000, as the Commissioner contends it can be distinguished, *we must then decline to follow that decision.*"

The opinion of the Supreme Court in the *Elbe case* did not resolve the conflict reflected in the foregoing quotation between the Ninth Circuit and the Fifth Circuit, but decided the case on a different factual basis.

(g) The conflicting opinions of the United States Court of Claims in the cases of *Berry Oil Company v. United States,* 25 Fed. Supp. 97 (certiorari denied) and *Heep Oil Corporation v. United States,* 32 Fed. Supp. 762.

(h) The opinion in the case of *Rialto Mining Corporation v. Commissioner* (C. C. H. Decision 11262-A), wherein the Board of Tax Appeals said:

> "We may leave on one side, however, the question of whether the lessee who has parted with his *full term* by his sublease still retains an estate in the land or merely a chose in action, since if the other factor here involved shall be decided in petitioner's favor it will be sufficient

to dispose of the case. *That factor is the retention of an 'overriding' royalty by the sublessor.*" (Italics ours.)

Despite the fact that in that case the Board recognized that the status of a mining lease was a question of Oklahoma law, it gave controlling effect to the presence of the overriding royalty.

(i) The denial of certiorari by the Supreme Court in the case of *Comar Oil Co. v. Burnet,* 64 Fed. (2d) 965, and that Court's subsequent decision in the case of *Thomas v. Perkins,* wherein emphasis was placed on the division orders as reflecting the interests of the parties. (For division orders in the instant case see Record, page 291 *et seq.*)

III.

Status of Local and General Law.

The local Texas Courts have established as a rule of property and a rule of taxation that royalties and oil payments are equivalent in their legal effect, and the General Law as evidenced by various decisions is to a like effect, particularly as to tax consequences.

The Supreme Court of Texas, in the tax case styled *State v. Quintana Petroleum Company,* 133 S. W. (2d) 112, cited Article 7146 of the Texas Statutes defining "real property for the purpose of taxation," and cited with approval the similar case of *Sheppard, State Controller, v. Stanolind Oil & Gas Company,* 125 S. W. (2d) 643, a decision by the Court of Civil Appeals, in which the Supreme Court had already denied writ of

error. The Court of Civil Appeals at page 648 in the case last cited said of "oil payments" (which it termed "oil bonus"):

> "The oil bonus, as we have seen, partakes in every particular of the nature of royalty and royalty bonus, except only that *its amount is limited.* It is analogous to an overriding royalty. And such it would in fact be if, instead of moving to the lessor, it moved to the lessee under an assignment of the lease."

(Similar in legal effect to Article 7146, mentioned in the *Quintana case, supra,* are Articles 1291 and 1292 of the Texas Statutes, which prescribe the elements of a conveyance in fee simple, all of which appear in this transaction.)

The highest Federal Court in the land has also used similar language in one of its most recent decisions dealing with oil transactions (*Anderson v. Helvering*). In that case this Honorable Court, speaking of the case of *Thomas v. Perkins,* said that the decision established that oil payments "should be given the same *tax consequences* as a provision for oil royalties."

The Fifth Circuit Court in the earlier *Laird case* [*Commissioner v. Laird,* 91 Fed. (2d) 498], speaking of the analogy between the assignor's rights to oil payments and to royalty, said:

> "As to both, he has an economic interest in the oil in place, and as to both, he is entitled to depletion."

However, the Court there held that the analogy could not be pressed to the point contended for by the Commissioner, to the effect that a decedent's estate

should be taxed on royalties and oil payments alike, by valuing both as of the date of death. The Commissioner's contention was summarized as follows by the Court:

> "As to the oil payments, the Commissioner makes his case out by insisting that these payments in reserved minerals until the sum fixed is reached are the same in their *legal incidents and effects* as royalty payments, both being reservations of oil as and when produced, the only difference being that the oil payments are to continue until a definite sum or value is obtained from them, the royalty payments are to continue indefinitely." (Italics ours.)

The fallacy of determining the nature of a transaction by the factor of whether an assignor has the right to receive royalty, or only oil payments, is revealed by the above quotations, thus leading to the conclusion stated by this Honorable Court in *Helvering v. Tex-Penn Oil Company, supra,* as follows:

> "* * * that in determining tax liability, taxing authorities must look through form to fact and substance."

The same rule is stated by this Honorable Court in the case of *United States of America v. Phellis* (257 U. S. 156), as follows:

> "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the 16th Amendment and income tax laws enacted thereunder."

Illustrative of the proper application of the rule thus prescribed by this Honorable Court is the follow-

ing quotation from the case of *Jefferson Gas Coal Company v. Commissioner,* 52 Fed. (2d) 120, at page 122:

> "* * * The real character of an instrument must be determined from the intention of the parties as gathered from a fair interpretation of the instrument as a whole. (Citing authorities.) Looking at the instrument as a whole, and the object sought to be obtained, that there is a *contract of sale of coal in place and not a lease is inescapable."* (Italics ours.)

ARGUMENT

There has probably been no case the issues in which were more litigated or the decision in which has been more discussed and applied and extended by the lower courts than the decision of this Honorable Court in the case of *Palmer v. Bender.* Beginning with the case of *Waller v. Commissioner,* 16 B. T. A. 574, 40 Fed. (2d) 892, in which certiorari was denied by the Supreme Court, and revived in *Herold v. Commissioner,* 42 Fed. (2d) 942 (no certiorari filed), and resumed in *Palmer v. Bender,* 49 Fed. (2d) 316, 57 Fed. (2d) 32, and finally decided in 287 U. S. 551, the case became almost a Magna Charta or Bill of Rights for taxpayers engaged in transactions connected with the oil industry. The case gave a liberal interpretation to a statute that was intended to encourage the discovery and development of oil fields, the importance of the oil industry having been impressed on all at the time of the World War. However, there was another statute designed equally for the same purpose, but made applicable only to individuals who, unlike corporations, were subject

to heavy surtaxes. This was what we have termed the Prospector's Relief Statute, which is here involved.

It is equally important to the oil industry that that Statute be given a liberal application.

Particularly is this true today. All of the current dispatches and comments indicate the importance of developing our oil reserves as rapidly as possible. One of the "O. P. M." officials is quoted as saying:

> "Every war machine that moves these days is powered with a gasoline or oil-burning engine."

Wm. P. Cole, Jr., Maryland Congressman, sometimes rated foremost authority on oil in the Congress of the United States, has just told the American Petroleum Institute at its recent meeting in California: "This is an oil war." He told the oil producers to be ready for a demand of some 5,000,000 barrels per day, about one-fourth more than the present production.

By far the largest oil producing State in the Union is the State of Texas, from which this case emanates. In this instance, however, we find the developer of one of the important Texas oil fields confronted with a serious tax problem which would largely deprive him of the benefit of his discovery and development, merely because his situation, in so far as the issues in this appeal are concerned, demanded the application of the Prospector's Relief provision, or at least the Capital Gains provision, of the law, instead of the Discovery Value Depletion provision that was involved in *Palmer v. Bender*. That this ruling emanated from a misconstruction of the Supreme Court's decision in the case

of *Palmer v. Bender* is reflected by the ruling of the Board on another phase of this appeal (the Gray leases), that was not carried to the Circuit Court. With reference thereto the Board said:

> "The contract covering the Gray leases is different from the contracts covering the other three leases. * * * Although the payments were measured by one-fourth of the net profits realized from the operation of the properties, and although there is no statement in the contract that those payments are to be made from any portion of the oil, nevertheless, this contract did not effect a sale of McLean's interest. It is unlike the contracts in the Elbe and Blankenship cases which purported to convey *all of the interest* of the assignors." (Italics ours.)

Apparently because the contract as to the Gray leases only covered an undivided three-fourths interest instead of McLean's full interest, the Board determined that McLean retained "an economic interest in a part of the oil in place," and that depletion was, therefore, allowable.

As to the phase of the instant case that was carried to the Circuit Court, regardless of what the Court might have ruled as to the other phase that was not presented there, it is plain that the Circuit Court felt obligated to rule that the "reservation of an additional royalty" was the determinative factor under the decision in *Palmer v. Bender*. Referring to that decision the Circuit Court said:

> "We are not at liberty to repudiate or, at this late date, to even question those principles."

And the Court pointed out that this was made the test in the case of *Cullen v. Commissioner, supra,* where it was determined that a part of the transfer was a sale and a part was a sublease, even though all of the leases were assigned as a part of one transaction and by the same instruments which imposed exactly the same obligations as to operation of all of the leases. The Board's opinion in that case said:

> "* * * We cannot agree that the transfer is divisible into a sublease as to all but three of the leases and a sale as to those three. The oral testimony and the documentary evidence refute respondent's argument that this transaction was divisible into separate transfers of one or more leases for varying considerations." (41 B. T. A. 1054.)

On the other hand, the Circuit Court said in the *Cullen case:*

> "We do not agree with the Board's holding that the transfer was not divisible. The facts support the commissioner's determination that the transfer should be broken down into two separate types of transactions."

In other words, in order to give the yardstick of "royalty or no royalty" controlling effect, the Court had to hold that the same parties to the same transaction had two separate intents as to the same general group of properties which were to be operated as a unit—(1) to create a sublease where it happened that a royalty was reserved, and (2) to make a sale where no royalty was reserved; a Doctor Jekyll and Mr. Hyde transaction. Neither side applied for certiorari in the

Cullen case, presumably because the question of allocation might dispose of it, upon the remand to the Board where it is still pending.

We firmly believe that no state rule of property could lead to the anomalous results reflected in the *McLean case* and the *Cullen case* due to the application of the royalty "yardstick." Certainly the Texas statutes do not contemplate that the presence or absence of a provision for royalty would be the controlling factor, in determining the character of title received by an assignee. In fact, Article 1291 provides that regardless of the form, a conveyance of lands (and minerals are a part of the land under the laws of Texas) "shall be deemed a fee simple if a less estate be not limited by *express words* or do not appear to have been granted, conveyed or devised by construction *or operation of law.*" Even an oil lease has been held in Texas to create a "determinable fee." The fact that the fee is determinable under a lease might reconcile the local law with the conclusion reached in *Burnet v. Harmel, supra,* as to such a lease not constituting a sale of a capital asset; but could in no way affect the status as to an assignment of a lease, such as is here involved.

In a day and at the hands of a court where a case like *Erie Railway Company v. Tompkins* could be decided and based not only on legal but constitutional grounds, in order to give effect to state rules of decision, it would seem that there would be more reason to urge also recognition of state rules of property (even when interpreting a Federal Revenue Act), where they do not run contrary to some policy of the

Federal Law. Here the policy of the Federal Law is to encourage and protect the developer of oil property who makes his contracts and conducts his transactions in reliance on the rules of property in the state where the property lies.

The case of *Palmer v. Bender, supra,* which has been relied on by the Circuit Court and the Board of Tax Appeals as the basis for denying the taxpayer relief under either the Capital Gains provisions or the Prospector's Relief provision, was a case where the Supreme Court went out of its way to reverse the judgment of the lower courts in order to extend the taxpayer relief. In other words the Court instead of invoking a technical rule to deny protection to the developer of an oil field applied a liberal rule to afford him protection.

The application for certiorari in that case contains on page 46 the following statement:

> "The trial court found as a fact that it was the intention of the parties to the Smitherman-Ohio transaction to effect a sublease." (Record 49.)"

(No such finding could possibly be made in the instant case in the face of the provision of the *stipulation* heretofore quoted to the effect that the transfer was considered by the petitioners as the sale or exchange of a capital asset.)

Regardless of that finding the Supreme Court in *Palmer v. Bender, supra,* speaking through its present Chief Justice, said:

> "It has been elaborately argued at the bar and

> in the briefs whether under Louisiana law the two instruments are assignments or subleases. We do not think the distinction material."

Interpreting this language the Board of Tax Appeals in the *Cullen case* (41 B. T. A. 1054), said:

> "The Supreme Court held it was immaterial whether the transactions were sales or subleases."

Whether this is a correct interpretation or not, it indicates that the body charged with the interpretation and application of our tax laws understands that the Supreme Court meant to hold that the substance of the transaction must be disregarded in order that the "form" or "rule of thumb" arising from the presence or absence of a right to receive royalty, under an assignment, might always control.

It is hardly believed that the Supreme Court meant by its decision in *Palmer v. Bender* that a transaction could not be a lease or a sale, according to the intent of the parties and the other terms of the instrument, irrespective of whether there existed any right in the grantor to receive either royalties or oil payments. Surely a party can make a lease or a sublease for a period of years in consideration only of the drilling of a well, in which he would have no direct interest but which would benefit the balance of his surrounding property. On the other hand, with equal certainty a party should be able to effectuate a sale of a seven-eighths mineral interest, reserving a one-eighth mineral or royalty interest, with a right of ingress and egress for the purpose of developing

his own interest. Thus, each transaction presents a different case for consideration by the courts.

The case of *Anderson v. Helvering,* 310 U. S. 404, is the latest expression of this Honorable Court pertaining to transactions of this nature. It aptly illustrates, we believe, the fact that this Honorable Court does not intend to extend the rule applied in *Thomas v. Perkins* (301 U. S. 655) to determine the ownership of income derived from oil payments. Obviously if that rule is not to be extended neither can the rule under which depletion was allowed in *Palmer v. Bender* be extended, because as said by this Court in *Anderson v. Helvering:*

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."

While this Court's opinion in the *Anderson case* speaks of giving the factor of the presence of "oil payments" in a transfer "the same tax consequences as a provision for oil royalties," it seems clear that the Court was referring only to the question of allowing depletion on such oil payments, as allowed on oil royalties, and not to the bearing of the presence or absence of either, upon the legal effect of a transfer. Nevertheless, the brief for the respondent (at page 4) in opposition to the petition for certiorari in the instant case, says:

> "In view of the recent affirmance of the principle of Palmer v. Bender, in the Anderson case, there is no occasion for further consideration of the issue in this case."

Conclusion.

In *Palmer v. Bender,* this Honorable Court gave a liberal interpretation to a statute allowing Discovery Value depletion, as an "act of grace." Since no income tax can be laid on anything except the "profit" derived from the disposition of a capital asset, there is more reason to give a liberal interpretation herein, particularly as to a statute that allows a taxpayer to use Discovery Value as a basis of determining the profit, like Section 102 does. Therefore, even if doubt exists, as it certainly does under the confusing decisions of the lower Federal Courts as to the determinative nature of a royalty reservation, that doubt should, we suggest, be resolved in favor of the taxpayer.

Regardless of whether or not this Honorable Court presently thinks that the situation of the petitioner would be changed in a review of his case, it seems to the petitioner that these matters causing confusion, uncertainty and doubt as to the taxpayer's position in sales and subleases should be reviewed and cleared up. This Honorable Court should reaffirm fundamental precepts and doctrines of the law so that they will not be abandoned and yield to the use of erroneous factors. There is no doubt as to the confusion and uncertainty on the part of taxpayers and their attorneys. They see that the Fifth Circuit Court's decisions are turning on a reserved "royalty" interest, or a reserved "oil payment" interest, but they do not see in the statutes or the decisions of the Supreme Court any warrant or justification for the use of reservations as being factors in determining the nature of a transaction.

Even if this Honorable Court should think that a reserved "royalty" should be a controlling factor in determining the nature of such transactions, it would be better to affirm that position by a definite decision, rather than deny this writ of certiorari, for there would still remain doubt and uncertainty in the latter event.

Respectfully submitted,

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Attorneys for Petitioner,
Marrs LcLean.

I, Palmer Hutcheson, do hereby certify that I am one of the counsel for petitioner herein, and that this Petition for Rehearing is presented in good faith, and not for delay.

PALMER HUTCHESON.